Global Counsel

British trade policy after Brexit: ruthless prioritisation required

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Summary

UK trade policy will require ruthless prioritisation if scarce diplomatic resources are to be deployed to the best possible effect. We provide advice based on a series of metrics. The US and China should be the top priorities, although for different reasons. The government should not spend too much time on India or Australia and it should largely forget about Canada. It is worth seeking to boost trade elsewhere in Asia, specifically in Japan, Korea and the ASEAN countries. The government would be advised to not overdo the Gulf. Finally, it should not neglect countries in Europe that are not members of the EU, specifically Russia, Turkey and Switzerland. There are likely to be significant opportunities in all three, although progress with Russia will be held back by a difficult political relationship.

Britain's new International Trade Secretary Liam Fox says he is scoping about a dozen free trade deals, which he hopes to be ready to sign when the UK leaves the EU. This is a daunting challenge as Global Counsel has explained in an earlier insight. It will require ruthless prioritisation if scarce diplomatic resources are to be deployed to the best possible effect. So where should Dr Fox focus his effort? This is partly a matter of judgement about what is obtainable when engaging with each potential interlocutor. But it should also be informed by a dispassionate assessment of where the economic opportunities are likely to be greatest. This note uses hard data to address this question. Some of the conclusions contradict the wisdom emerging in government about exactly where the biggest new trade opportunities are to be found.

The challenge for UK plc

The flexibility for the UK to negotiate its own trade deals and to make its own trade-offs in those deals was an important, if contested, element of the campaign for Britain to leave the EU. Since the vote, the new government has underlined its intent by creating an entirely new department – the Department for International Trade – to pursue this. The new department's most high profile activity will be the negotiation of free trade agreements with countries outside of the EU. But it will also take on two other responsibilities that are very important for British exporters. One is trade promotion. The department is absorbing UK Trade and Investment which has until now been responsible for encouraging and helping British companies to enter new markets and for the promotion of UK exports overseas. It will also have responsibility for day-to-day negotiations with other countries to address specific market access and regulatory issues in individual countries outside of formal FTA negotiations. This type of activity is particularly important for exporters of services and British investors.

There is no one single metric that alone identifies where the untapped trading opportunities are to be found. This is partly because the opportunities around the world may take varying forms and the obstacles to exploiting these are very often different. In some countries, the opportunity comes from the opening up and rapid growth of a nascent market, while in others, it is from better access to a large and well-established sector. In some countries, the barriers take the form of a tariff wall that makes it prohibitively costly to export goods, while in others, particularly in service sectors, it is regulations or the way they are applied that holds exporters back. In some other countries, it may simply be the case that, for whatever reason, British companies don't do a particularly good job at exploiting the opportunities that already exist.

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Below, we use five metrics that seek to reflect these differences. In each case we identify and rank the top 15 non-EU countries for which data is available. The metrics have all been constructed to be expressed in monetary terms, which means the rankings are cardinal, rather than simply ordinal. This means if the score for Vietnam is three times that of Canada, the opportunity in Vietnam is three times as great. This allows us to get around the problem of comparing small, fast growth economies and larger, more established markets. None of the metrics alone is perfect. In all cases, we are implicitly assuming that the recent past is a good guide to the future. Taken together, however, they provide as good a guide as any as to how the UK government should prioritise its trade policy.

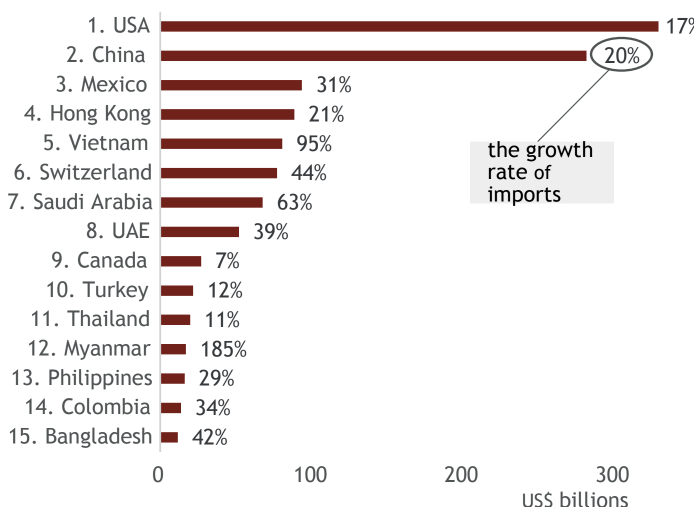

Fig 1. Increase in the value of imports, 2010 to 2015
Source: CEIC; Note: Myanmar from 2011 to 2015

Metric one: go for growth

The simplest approach is to prioritise those markets that have been expanding the fastest. Fig 1 shows countries ranked by the increase in the total value of imports between 2010 and 2015. The US and China top the list by virtue of their sheer scale, even though their growth rates are lower than most of the smaller economies, which also tend to be more open. If there are surprises in this ranking, it is in the countries that follow. None of the other BRICS make it onto the list and instead it is mostly smaller, more dynamic and more open emerging economies. Mexico and Vietnam stand out, with the latter seeing imports almost double over this period. The two Gulf countries on the list show how the past may not always be a good guide to the future, as the rapid growth in imports in these countries reflects high oil prices, which have since fallen back.

Metric two: aim at the barriers

Another approach is to aim where the trade barriers are highest. Fig 2 below ranks countries according to the tariffs that are currently being paid by UK exporters. This is the most direct barrier to trade in goods. It does not, however, reflect either non-tariff barriers to trade in goods or barriers to trade in services, which are typically more related to regulation. However, these other types of barrier to trade are typically positively correlated with tariff barriers, as they reflect a protectionist mindset in government. This metric shows that China is the biggest problem by far for UK exporters. India comes a distant second even though the average applied tariff is similar, as the volume of trade is so much lower. The US shows how a country with only a very modest average tariff barrier can still be an important target for trade policy if the volume of trade is large enough to warrant this.

High applied tariffs are generally there for a political reason. The difficulty in overcoming a protectionist mindset means deals aiming directly at high applied tariff barriers can often be the hardest to strike. This is also an area where the past is an imperfect guide to the future for an important reason. The tariff barriers currently faced by UK exporters reflect the trade preferences that have been negotiated by the EU and which will need to be renegotiated by the UK following Brexit. This alone will present the UK with a significant challenge. If the UK is unable to negotiate similar terms, and quickly, then the tariff bill for exporting to a country like Korea, which does not make it onto the list below, will rise sharply.

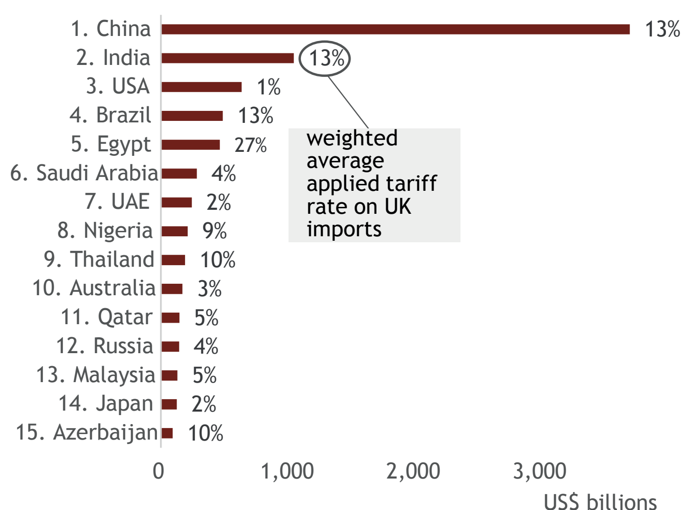

Fig 2. Tariff duties paid by UK exporters, most recent year data available
Source: WITS, GC calculations;
Note: Switzerland omitted as data erratic

Metric three: tackle underperformance

A third approach is to concentrate on those markets where UK exporters have failed to exploit opportunities in recent years for one reason or another. Gauging this is not straightforward. The approach taken here is to compare UK exports in recent years with the average of three EU peers – France, Italy and Germany – after adjusting for differences in GDP. These countries provide a reasonably good benchmark as they are near neighbours, they currently face the same or similar trade barriers in other countries, and they are similar in size and openness. They are, of course, not perfect comparators, partly because they have different sectoral strengths, which are also reflected in their export opportunities. This is one reason why we use all three, rather than any single one, as the benchmark.

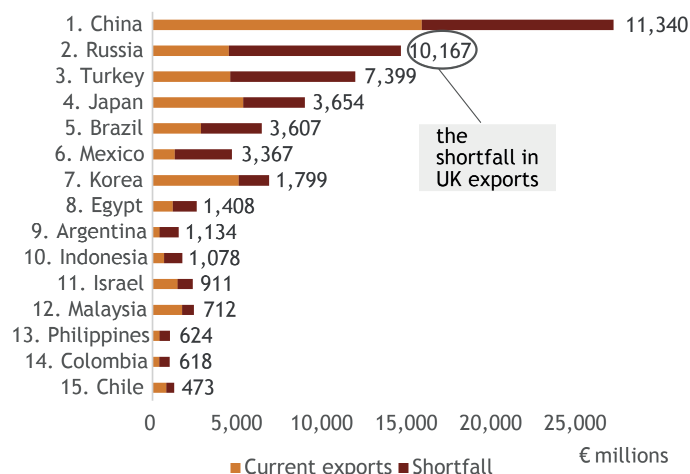

Fig 3. Average shortfall in UK exports relative to EU peers, 2010 to 2015
Source: Eurostat, GC calculations

When we compare the UK's export performance with these countries, we find the UK is already good in some parts of the world, notably the US, Hong Kong, Switzerland and Canada. This partly reflects cultural and linguistic ties. What is more revealing, at least for the purpose of identifying new opportunities, is where the UK is currently underperforming, which is what Fig 3 shows. The standout conclusion is that the under-performance is greatest in many of the fastest growing emerging economies, with over €11bn of untapped export potential – equivalent to about 0.5% of UK GDP in 2015 – in China alone. The exploited potential in Russia is not far behind, at just over €10bn.

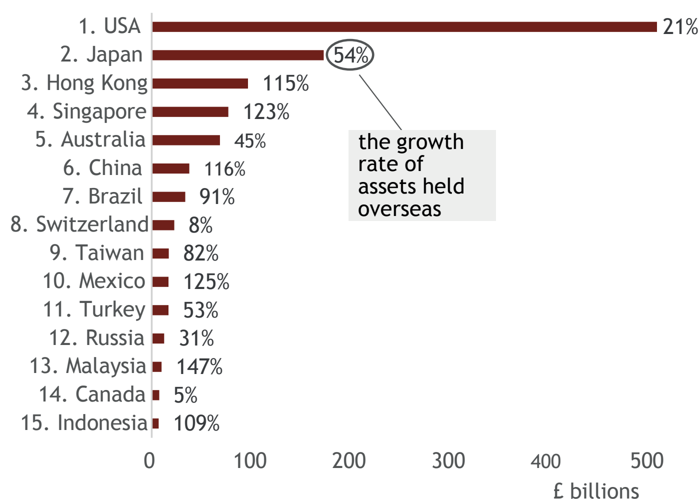

Fig 4. Increase in British-owned assets held overseas, 2009 to 2014
Source: Office of National Statistics Pink Book

Metric four: follow the (British) money

This metric is based on the observation that export opportunities are often correlated with direct investment overseas as this can provide a supply chain that leads back to UK producers either within the same group or through other companies. Not all outward FDI takes this form, but enough does to warrant the inclusion of this metric. The country coverage of data on outbound FDI is limited, so in Fig 4 above we use the change in aggregate external assets as a proxy. This includes portfolio and other investments, in addition to FDI, and the values are affected by changes in exchange rates.

Fig 4 shows that over the past five years, British-owned assets held overseas have increased most in the US. China ranks much further behind, in just sixth place, even though British-owned assets there have more than doubled during this period. The metric shows there have been large increases in assets held in a clutch of Asian economies – including Japan, Hong Kong, Singapore and Taiwan – suggesting these may be locations where new opportunities for exporters are also emerging.

In all of these countries, there is likely to be a need for in-market support for UK FDI once it has been made. This may take the form of regulatory dialogue or encouraging domestic reform to expand the opportunities for British firms. This is not about high profile deal making. It requires a hard daily grind by diplomats, government departments and UK public bodies with the relevant expertise and the lead in the policy areas concerned. But it is an important part of any country's trade policy.

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Metric five: exploit UK strengths

The final metric is based on the observation that often it is best to focus on your strengths. The UK has a strong comparative advantage in services and, in particular, three sub-sectors: financial services, insurance and pension services, and other business services. These together account for almost 60% of total UK services exports. Fig 5 below shows where the import markets for these sectors have increased most over the past five years. Perhaps surprisingly, the increase in the market size has been greatest in Japan, ahead of the US, albeit from a smaller base. A number of other Asian economies also feature on this list, although China is just fourth, with its 34% growth lagging behind the 56% average increase in China for all service sector imports during this period, suggesting China is not yet growing and rebalancing in a way that is advantageous to the UK's strongest export sectors.

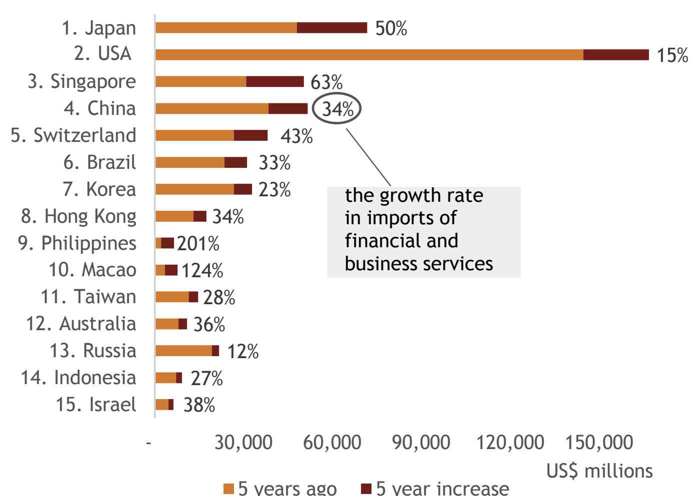

Fig 5. Increase in value of financial and business services imports, 2010 to 2015
Source: UNCTAD, GC calculations;
Note: includes insurance and pensions services, financial services and other business services

Bringing it together: how Dr Fox might allocate his time

Based on these five metrics, what can we say about the priorities for British trade policy? As noted above, none of the metrics is perfect. They each reflect different ways of looking at the question. Taken together, some of their imperfections are likely to cancel out. If we make the (arbitrary) assumption that each metric should be given equal weight, we can produce a single ranking and a clear guide to how the British Government should allocate its scarce resources to trade policy. The table in the annex shows the top 25 countries that emerge.

Based on this, here are five conclusions about the government's priorities. First, the US and China stand out at the top of the list, although for different reasons. In China, the challenge is reducing barriers and catching up on EU peers who have a far superior export performance even though they face similar obstacles at present. In the US, the opportunities are suggested by the increase in British investment there and by the increase in imports of financial and business services.

Second (and more controversially), the UK government should not spend too much time on India or Australia and should largely forget about Canada. India only features because the existing barriers to exporting there are formidable, but that does not mean they would be easy to negotiate away, particularly as India's top demand of the UK is likely to be on visas and migration. The strongest rationale for Australia is the substantial increase in investment there by UK-based entities, but beyond that the case is weak. Canada barely features in the rankings. Perhaps the strongest argument for focusing on Canada at all is that it is on the verge of implementing a trade deal with the EU which would see British exporters disadvantaged when the UK leaves the EU, but the same problem will arise when the EU signs other deals in the future.

Third, it is worth spending time seeking to boost trade elsewhere in Asia. Japan is the third ranked country, while ASEAN countries taken together would rank even higher. Add in Korea and the opportunity is comparable with the US or China. In each of these countries, the strongest rationale is from the fast growth in imports of financial and business services, which matches UK strengths. Recent investment in these countries by British entities has also been high, creating other opportunities, while there is also plenty of catching up to do with European exporters, particularly in Japan and Korea.

Fourth, don't overdo the Gulf. This has always been popular with government ministers, partly because the Gulf countries often like to do business government-to-government. The import markets of Saudi Arabia and the UAE have grown in recent years, helped by oil prices that have been high until recently, but there is not much else to suggest these countries are worth substantial effort. Other countries in the region, such as Qatar and Kuwait, don't even make it into the top 25.

Finally, don't neglect countries in Europe that are not members of the EU. Russia, Turkey and Switzerland all make it into the top ten, although for different reasons. In the case of Russia and Turkey, it is above all else because of a massive

deficit in the UK export performance relative to the other major European economies. In the case of Switzerland, it is more to do with the growth in the import market, especially in the UK strengths of financial and business services. There is an additional rationale for paying particular attention to Turkey and Switzerland, which is that for many years the commercial relationship has been largely mediated through the EU, which will now change. By contrast, in the case of Russia, the difficult political relationship, and Ukraine-related sanctions, will act as an impediment for the time being.

One final caveat. There will inevitably be important UK firms who – justly – see opportunities in markets that do not come top of these lists. But an important and difficult part of the policymaking process is stepping back and seeing the bigger picture. That is what Dr Fox and his new department need to do now.

This Global Counsel Insight note was written by Gregor Irwin, Chief Economist at Global Counsel.

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The views expressed in this note can be attributed to the named author only.

Annex. Overall country ranking

The scores for each metric shown in the Table below are the shares of the sum of the values for the top 20 economies in each case. Because different countries appear in the top 20 for each metric, some of the economies shown below do not show any score for some of the metrics. In total, 43 economies appear in the rankings. The table below shows the top 25 based on their average scores across all five metrics. Combined totals for ASEAN and Mercosur countries are shown at the bottom of the table for reference.

The way this table has been constructed allows for a simple interpretation for each score. These may be regarded as the percentage of resources that should be allocated to any one economy according to each of the metrics. Accordingly, if each of the metrics is given equal weight, the average score shows the percentage of resources that should be allocated to each country. The conclusions above are based on this average.

	Country	Metric 1 Imports	Metric 2 Barriers	Metric 3 Peers	Metric 4 Investment	Metric 5 Strengths	Average
1.	China	22.6	43.9	23.1	3.3	9.7	20.5
2.	USA	26.5	7.5	-	45.0	16.2	19.0
3.	Japan	-	1.5	7.4	15.3	17.4	8.3
4.	Russia	-	1.7	20.7	1.1	1.8	5.0
5.	Brazil	-	5.8	7.3	3.0	5.6	4.3
6.	Singapore	-	-	-	6.8	14.3	4.2
7.	Turkey	1.7	-	15.0	1.5	1.0	3.9
8.	Hong Kong	7.0	-	-	8.6	3.2	3.8
9.	Mexico	7.4	-	6.8	1.5	1.2	3.4
10.	Switzerland	6.1	-	-	2.0	8.4	3.3
11.	India	0.8	12.4	-	0.4	-	1.8
12.	Australia	0.9	2.0	-	6.1	2.1	2.2
13.	Saudi Arabia	5.4	3.4	-	0.4	-	1.8
14.	Korea	0.9	-	3.7	-	4.5	1.8
15.	Egypt	-	5.5	2.9	0.6	-	1.8
16.	UAE	4.1	2.9	-	-	-	1.4
17.	Vietnam	6.4	-	-	-	-	1.3
18.	Philippines	1.3	-	1.3	0.4	3.1	1.2
19.	Malaysia	0.9	1.5	1.4	0.9	1.0	1.1
20.	Indonesia	-	0.9	2.2	0.6	1.4	1.0
21.	Thailand	1.6	2.2	-	0.4	-	0.8
22.	Taiwan	-	-	-	1.5	2.3	0.8
23.	Canada	2.1	0.8	-	0.6	-	0.7
24.	Macao	-	-	-	-	3.1	0.6
25.	Israel	-	-	1.9	-	1.3	0.6
	ASEAN	*9.9*	*2.5*	*4.9*	*8.7*	*19.9*	*9.2*
	Mercosur	*0.0*	*6.6*	*9.6*	*3.0*	*5.6*	*5.0*

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